

Message Text

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ACTION EUR-12

INFO OCT-01 EA-10 ISO-00 CIAE-00 DODE-00 PM-05 H-01
INR-10 L-03 NSAE-00 NSC-05 PA-01 SP-02 SS-15
USIA-06 AID-05 COME-00 EB-08 FRB-03 XMB-02
OPIC-03 LAB-04 SIL-01 OMB-01 /098 W
-----077236 011840Z /43

R 011803Z MAR 78

FM AMEMBASSY LONDON
TO SECSTATE WASHDC 3685
TREASURY DEPT WASHDC
INFO AMEMBASSY PARIS
AMEMBASSY BONN
AMEMBASSY ROME
AMEMBASSY TOKYO
AMEMBASSY BRUSSELS

C O N F I D E N T I A L SECTION 01 OF 02 LONDON 03365

USOECD ALSO FOR EMBASSY
USEEC ALSO FOR EMBASSY

E.O. 11652: XGDS-1
TAGS: EFIN, OECD, UK
SUBJECT: UK EXCHANGE CONTROLS

SUMMARY: UK TREASURY CONSIDERS THAT THE MOST MEANINGFUL PART OF CAPITAL MOVEMENT LIBERALIZATION SINCE LAST OCTOBER HAS FAVORED THE U.S. IT SUGGESTS U.S. BE PRAGMATIC AND LOOK AT SUBSTANCE RATHER THAN FORM. IN PRIVATE, UK TREASURY ALSO APPEARS TO RECOGNIZE US DOES HAVE SOME GROUNDS TO PROTEST "ON PRINCIPLE" BUT IT IS UNLIKELY THIS WILL BE FORMALLY ACKNOWLEDGED. THERE WILL BE FURTHER PRESSURE FROM EC FOR UK TO MEET ITS FORMAL TREATY COMMITMENTS ON CAPITAL LIBERALIZATION TO EC MEMBERS. THERE WAS NO INDICATION FROM U.K. SIDE THAT WHEN THIS IS DONE IT WOULD BE EXTENDED BEYOND EC MEMBERS. END SUMMARY

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1. TREASURY REPS CALLED ON KEN COUZENS, SECOND PERMANENT SECRETARY, H.M. TREASURY; MARY HEDLEY-MILLER, UNDER SECRETARY AND C.H.F. HODGES, ASSISTANT SECRETARY, ALSO PARTICIPATED. TREASURY REPS REVIEWED CONTENTS OF U.S. NOTE, REMARKED THAT IN 1976 UK HAD QUITE PROPERLY AND APPROPRIATELY CALLED ON SWAPS, IMF AND CENTRAL BANKS AND U.S.

TREASURY IN BASLE AGREEMENT. ASSISTANCE CAME FROM COUNTRIES OUTSIDE THE EC. WE COULD NOT HELP BUT REMARK ON DISCRIMINATORY ASPECTS OF UK LIBERALIZATION CITED IN U.S./. NOTE; HOPED UK WOULD RECALL THAT IT WAS PART OF A LARGER SYSTEM THAN JUST EC; CITED ARTICLE 1 D OF OECD CODE OF LIBERALIZATION OF CAPITAL MOVEMENTS WHICH AS A GENERAL UNDERTAKING ASKS MEMBERS TO ENDEAVOR TO EXTEND LIBERALIZATION TO ALL IMF MEMBERS.

2. COUZENS SAID U.S. SHOULD LOOK AT SUBSTANCE RATHER THAN FORM. LIBERALIZATION IN OCTOBER REMOVED SOME DISCRIMINATION, ALLOWING NON-EC MEMBERS TO OBTAIN STERLING TO FINANCE DIRECT INVESTMENT IN CERTAIN AREAS (LONDON 17700, 1977). ADMITTEDLY, THIS IN PART WAS AIMED AT DOMESTIC JOB CREATION, BUT IT WOULD AID U.S. DIRECT INVESTORS. THE LARGEST ELEMENT OF THE JANUARY PACKAGE AND ONLY ONE OF CONSEQUENCE WAS REMOVAL OF THE 25 PERCENT SURRENDER REQUIREMENT TO MAKE EASIER PORTFOLIO INVESTMENT; THE U.S. WOULD ALMOST CERTAINLY BE THE LARGEST GAINER. THESE TWO MEASURES WOULD AID U.S. MORE THAN ANY OTHER SINGLE COUNTRY. THE OTHER ELEMENTS RESPONDED TO EC PRESSURE; WHAT THE EC COULD HAVE DEMANDED WOULD HAVE BEEN POLITICAL LY DIFFICULT. WHAT THE U.K. CAME UP WITH WENT AS FAR AS MINISTERS COULD GO. U.K. RECOVERY IS STILL FRAGILE AND CONVALESCENT; IT IS NOT ROBUST. PROGRESS MUST BE MADE CAUTIOUSLY. WHAT WAS EXTENDED TO THE EC "DID NOT HAVE AN CONFIDENTIAL

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AWFUL LOT TO IT." HEDLEY-MILLER CALLED IT "PEANUTS, AN UNBELIEVABLE MINIMUM." (HEDLEY-MILLER STATED THAT THE UK WAS IN AN EXTREMELY PRECARIOUS POSITION IN THAT ITS OBLIGATIONS COULD FORCE THE VIRTUAL DISMANTLING OF ITS CAPITAL CONTROLS WITH EC MEMBERS, A PROCESS THAT SHE

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VIEWS AS POTENTIALLY DANGEROUS. THIS IN PART REFLECTS
SOPHISTICATION OF U.K. FINANCIAL MARKETS.)

3. TREASURY REP REPLIED THAT JUST AS UK HAD CORRECTLY BENEFITTED FROM THE SYSTEM, SO TOO IT HAD OBLIGATIONS TO NON-EC MEMBERS. HEDLEY-MILLER BECAME VISIBLY ANNOYED, SAYING UK THROUGH ALL ITS DIFFICULTIES HAD NOT CUT AID LEVELS. IT WAS PREPAYING IMF; FIRST CONCERN WOULD REMAIN DEBT REPAYMENT AND PROTECTION OF RESERVES RATHER THAN CAPITAL LIBERALIZATION; LECTURES AND FORMAL DIPLOMATIC NOTES FROM THE U.S. WERE NOT PARTICULARLY WELCOME.

4. COUZENS SAID H.M. TREASURY WAS WORKING ON A RELAXATION OF ATTITUDES, BUT IT WAS "VERY DIFFICULT" FOR THIS GOVERNMENT. THE UK BECAUSE OF THE FRAGILITY OF ITS SITUATION AND THE POLITICAL CLIMATE WOULD NEED TO PROGRESS GENTLY.
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HE RECOGNIZED THE U.S. WAS PROTESTING ON A POINT OF PRINCIPLE. WHAT THE UK HAD DONE WAS DONE UNDER PRESSURE. THE UK WOULD APPROACH THE GENERAL ISSUE PRAGMATICALLY AND TAKE REGARD TO UNDERLYING REALITIES. IT BELIEVED ARTICLE 10 OF THE OECD CAPITAL CODE JUSTIFIED U.K. ACTION

5. HODGES ADDED THAT THE UK WOULD BE UNDER CONTINUING PRESSURE FROM THE EC TO MEET ITS ALREADY OVERDUE COMMITMENTS TO CAPITAL LIBERALIZATION FORMALLY AGREED TO IN THE TREATY OF ACCESSION. TREASURY REP CAUTIONED UK OFFICIALS THAT US CONCERNS OVER DISCRIMINATORY LIBERALIZATION WOULD NOT DISAPPEAR.

6. FYI HMTREASURY WILL PREPARE A FORMAL REPLY TO U.S.

NOTE. IT IS UNLIKELY UK WILL FORMALLY ACKNOWLEDGE JUSTIFICATION FOR U.S. CONCERNS; IT WILL PROBABLY OFFER VINDICATION OF ITS ACTIONS BASED ON SUBSTANCE OF U.K. ABOVE ARGUMENTS. END FYI

7. IN LUNCHEON CONVERSATION WITH JOEL BARNETT, MP, CHIEF SECRETARY AND HEALEY'S NUMBER TWO, TREASURY REP MADE SOME OF ABOVE BASIC POINTS. BARNETT WAS NOT WELL VERSED, BUT SAID U.S. SHOULD NOT SEE THIS AS AN INDICATION OF A "LITTLE ENGLAND ATTITUDE," IT REFLECTED EC PRESSURE TO MEET A TIMETABLE OF FORMAL OBLIGATIONS.

8. IN A SEPARATE CONVERSATION DEALING WITH U.S. NOTE, KIT McMAHON, DIRECTOR OF THE BANK OF ENGLAND, TOLD THE TREASURY REPRESENTATIVE IT IS FAIRLY PUBLIC KNOWLEDGE THAT THE BANK OF ENGLAND HAS PRESSED FOR GREATER LIBERALIZATION OF CAPITAL MOVEMENTS BUT DID NOT CARRY THE DAY. IN THOSE AREAS IN WHICH THERE WAS DISCRIMINATION IN FAVOR OF THE EC, THE GOVERNMENT WENT AS FAR AS IT CONSIDERED CONFIDENTIAL

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ERED ITSELF ABLE TO. THE U.K. CONSIDERS ITS ECONOMIC RECOVERY MORE FRAGILE THAN APPARENTLY DOES THE U.S. IF ONE LOOKS AT NET RESERVES, OR OTHER MEASURES OF RESERVES MEASURED AGAINST FUTURE DEBT REPAYMENT; THE UK IS NOT YET FULLY CONFIDENT OF ITS POSITION.

9. REFERRING TO "SUBSTANCE" OF THE ISSUE, McMAHON SAID ONLY ON MINOR ISSUES DID THE U.K. DISCRIMINATE IN FAVOR OF THE EC. THE MAIN ITEM, ABOLITION OF THE 25 PERCENT SURRENDER RULE, WAS THE SIGNIFICANT STEP AND IT WAS EXTENDED TO ALL. McMAHON EXPRESSED "THE HOPE" THAT FURTHER LIBERALIZATION MIGHT BE EXTENDED TO ALL. THIS SAID, THERE WERE TREATY OBLIGATIONS TO THE EC AND HE "COULD NOT PROMISE THERE WOULD NOT BE MORE LIBERALIZATION DIRECTED ONLY AT THE EC" HE ACKNOWLEDGED THAT THE U.S. NOTE WOULD REMIND CERTAIN CABINET MEMBERS AND TUC OFFICIALS THAT THEY ARE IN A SYSTEM WHICH IS LARGER THAN SIMPLY THE EC. THIS SAID, HE ASKED THAT THE U.S. BEAR IN MIND "WE HAVE FOUGHT OFF PRESSURES FROM THESE DOMESTIC SOURCES FOR IMPORT CONTROLS". IT WAS NOT A TOTALLY ONE-SIDED BATTLE.

10. COMMENT: DESPITE SOME PIQUE FROM HMTREASURY, EMBASSY BELIEVES THE DELIVERY OF NOTE AND FOLLOW-UP HAS BEEN A USEFUL EXERCISE, AND WILL AID THOSE IN HMG WHO ARE INCLINED TO TAKE A LARGER OR MORE LIBERAL ATTITUDE TO CAPITAL MARKET LIBERALIZATION.

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